RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE1958

PO Box 1759, La Jolla, California 92038 — 17 Letters Per Year - $250 Annually

LETTER 1328

**December 12, 2001**

Nov. 23, DJIA 9959.71; PTI 5338; AD Ratio -1.51
Nov. 30, DJIA 9851.56; PTI 5334; AD Ratio -1.68
Dec. 7, DJIA 10049.46; PTI 5338; AD Ratio -1.14
Dow yield: 1.80% Dow p/e: 27.8
Gold 50-day MA: 274

**THE PICTURE**: I have never seen so much baloney, nonsense and pure BS coming out of Wall Street, its analysts and strategists, as I have seen at present.

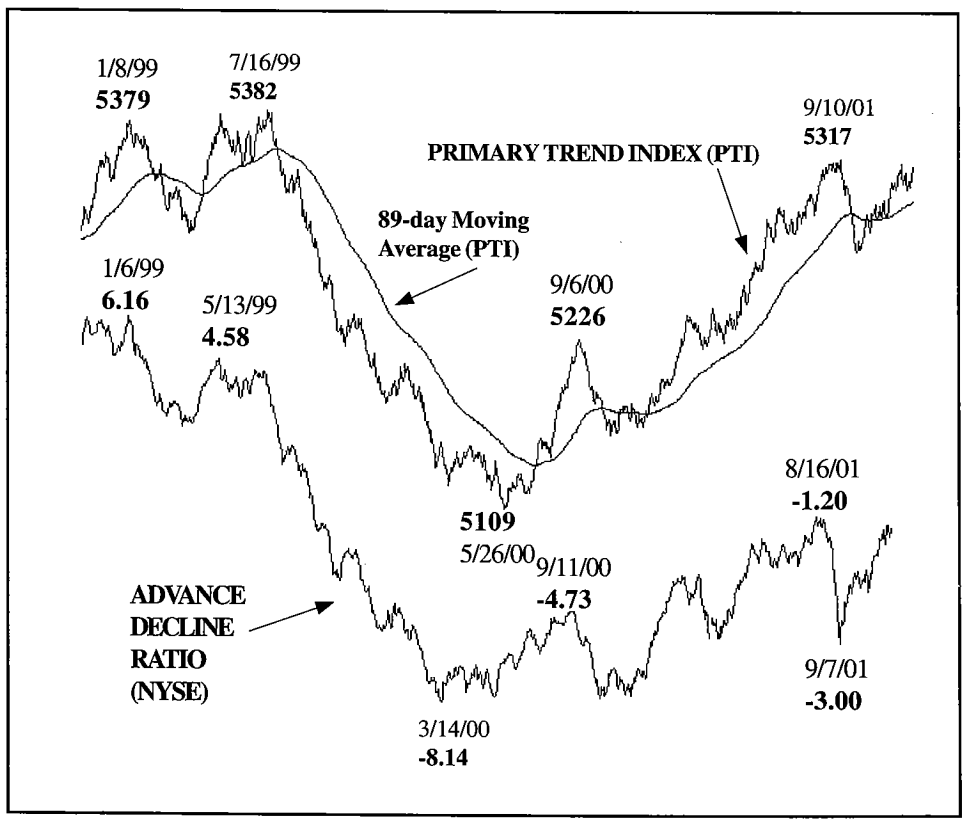
And unfortunately, the press does not have sophisticated analysts or market experts doing the stories that we read in the newspapers and magazines. No, the people who write the stories are reporters and writers, and they write what the so-called "experts" tell them. The experts are interviewed by these reporters, and the result, the output, is what we read in the newspapers and magazines.

For months various Fed governors have come out (maybe once or twice each week) announcing one of the following: "There is no recession," or "if it's going to be a recession it will be short and shallow" or "if it is a recession it's so mild that I'd be hard-pressed to call it a recession," or "yes, you might stretch it and call it a recession, but it will be over by early next year."

Then there's the latest utter nonsense. The Dow is up 20% therefore "we're in a new bull market." I don't know who started this dopey latest rumor, but suddenly all the newspapers pick this new definition.

On this "up 20% is a new bull market" definition, during 1929 to 1932 we saw six "new bull markets." How's that? During 1929 to 1932, during the greatest bear market in US history, there were six upside corrections. Of those six, five were over 20% in extent.

This is the way those six corrective rallies ran within the great 1929-32 bear market. The first corrective rally following the crash took the Dow up 49%. The second rally took the Dow



up 16% — this was the mildest rally. The third rally advanced the Dow 23%. The fourth took the Dow up 29%. The fifth rally took the Dow up 35%. And the sixth rally just prior to the final low advanced the Dow 25%.

You think that was unusual? It wasn't at all. In fact, we have a modern comparison at our fingertips. It's the bear market in the Nasdaq, which may or may not be over. So far, we've seen six rallies in the Nasdaq. The first took the Nasdaq up 19%, the second took the Nasdaq up 35%, the third was up 16%, the fourth advanced the Nasdaq 24%, the fifth up 41%, and the sixth and latest up 36%. And as I said, the bear market in the Nasdaq is (I believe) not over.

OK, Russell, when does a bear market end?

A bear market ends when the market produces GREAT VALUES in stocks as it did in 1932, 1942, 1949, 1974, and 1982. Historically, when those great values finally appear they are confirmed by the pattern of the D-J Averages.

What about earnings? The price earnings ratio, the P/Es for the Standard & Poor's 500 as stated by *Barron's*, is now sky-high. *Barron's* lists the P/E for the S&P 500 at 31. And for the S&P 400 Industrials *Barron's* lists the earnings at 37. Just as bad, the dividend yield on the S&P 500 is 1.36% and for the S&P Industrials it is 1.11%.

Then there's the problem of the "E" in P/E. What are the earnings? Well, for one thing we know the earnings are phony. The new phrase for today's earnings is "pro forma." This is really whatever a corporation's accountant says the earnings are.

It used to be that dividends were important. In fact, investors looked to cash dividends as the ultimate source of share value. Dividends are pocketable returns. A stream of dividends were considered the ultimate safety device since a steady stream of dividends guaranteed that in time you would receive the full return on your investment.

Today, with minuscule or no dividends at all, investors are forced to depend on earnings. And for any kind of return, investors are forced to depend on RISING earnings. This, I believe, is what is putting such a massive emphasis on growth. No growth = no appreciation, and no appreciation and no dividends = dead wood, being stuck in stocks that go nowhere. Your money is tied up in total dead wood.

As for accounting, here's what *Business Week* says in its editorial (Nov. 26): "A stricter adherence to accounting rules won't solve the entire problem. GAAP, the generally accepted accounting principles, allow all kinds of one-time expenses and non-cash charges. This obscures the performances of ongoing operations. No one can fathom what are the true operating earnings because there are no guidelines as to what constitutes an extraordinary expense.

"The result is total confusion. Take earnings per share for the S&P 500 Stock Index for the second quarter: Under Thomson Financial/First Call standards, it is $11.82. But it's $9.02 according to S&P, and $4.83 under GAAP. How can investors make intelligent decisions?"

Russell Answer: They can't make intelligent decisions. The best decision is to accept the thesis that a primary bear market is in progress, and to stay invested during a primary bear market is the prescription for losses.

Right now, according to Standard & Poor's the earnings estimate for 2002 is $54. But Doug Cliggott (who seems to be the reigning guru on Wall Street) puts his estimate at $34. If Cliggott is correct and if his figures become accepted, then stockholders are in for a bad time.

Of course, the big shocker would be if all the talk of an upturn in the economy in 2002 turns out to be nothing but hopes and

wishes and nonsense. If that happens, well – the bear market "will be back" as far as Wall Street is concerned, and all of the bunk that we're hearing today will have served to cost investors millions of dollars.

Back in September 1999 I called a primary bear market under Dow Theory. Since then we've seen a lot of action in the Dow and the S&P, and we've seen a collapse in the Nasdaq.

At the time I warned, or I should say I predicted, that the Fed would fight any downturn "tooth and nail." I was too conservative. The Fed has panicked, dropped rates 10 times in a row and literally flooded the markets with liquidity.

The Fed is having a hard time of it, because they helped build the great bubble which took the various markets to absolutely absurd levels. Now with corporations and individuals choking on debt, the Fed is begging them to take on more debt in an effort to thwart the downward pressure of the bear.

Looking ahead, I said that Fed action might result in the kind of mini-bull, mini-bear action that we saw during 1966 to 1974. I realize that most of my subscribers were not around or not dealing with the markets during 1966 to 1974, so I want to recount what happened during those years.

Following are a list of the mini-bear markets which occurred during 1966 to 1974. During February 1966 to October 1966 the Dow lost 25%.

During December 1968 to May 1970 the Dow lost 36%.

During January 1973 to December 1974 the Dow lost 45%.

As for the mini-bull markets that occurred during the 1966 to '74 period, we have October 1966 to December 1968 when the Dow rose 32%.

During May 1970 to January 1973 the Dow rose 66%.

That gives you some idea of the difficulty and complexity of the entire 1966 to 1974 bear market. By the time that bear market was over, most investors had been "beaten to death." They were through with the stock market.

It took the lows of 1982 to bring large interests back into the market with enough buying power to turn the tide. But for the sake of history, the entire period from 1966 to 1982 was a period of frustration and mostly losses.

The Dow hit a high of 995.15 in 1966. At the lows of 1982 the Dow had fallen to 776.92. That was 16 years of frustration for investors with most having lost money during that period. At the lows of 1982 the S&P was selling at 7.9 times earnings (in 1980 it was selling at 6.8 times earnings), in 1982 the yield on the S&P was 6.3%, the price to book was 0.97, and price to sales was 0.33, and I might add that the bond yield was 12.2%.

No two bull markets and no two bear markets are the same. None start exactly the same and none end exactly the same. However, going over history the best gauge of bull market tops and bear market bottoms are VALUES. The pattern of the stock averages merely confirm the values.

Obviously, I don't know what will produce great values in this bear market. It could be just declining earnings, it could be a severe recession or even a depression, it could be a war, it could be a dollar collapse – your guess is as good as mine (maybe better than mine).

But I do think that this bear market will only end with a decline to the point where stocks provide great values. One characteristic of a bear market bottom is depressed investor sentiment. Aside from poor earnings, it is this depressed psychology that gives us the great values.

Another way of putting that is that it's the decline in price/earning ratios that gives us the great values. If a stock is throwing off $2 in earnings and it sells for 20 times earnings it will sell for $40. If the same stock throwing off the same $2 in earnings sells for 7 times earnings it will sell for $14. Two items may have changed, the TREND of earnings and investors' sentiment.

**INVESTMENT POSITION:** As I write, the Dow has crossed above the 50% or halfway level of the entire bear market. If you remember, the bear market in the Dow started at 11722 and hit its September 21, 2001 low at 8235. The halfway level was 9978.

That level was bettered decisively on December 5. So the question is – is this still a bear market? My answer is yes, it is. And the bear market is working out much as I originally thought it would. I originally suggested that this bear market would look a lot like the extended, tortuous bear market of 1966 to 1974.

By that I meant that we would see the Fed fight the bear with an all-out campaign of liquidity and lower rates. I said the Fed would fight the bear "tooth and nail," which is exactly what the Fed has done.

This process, I thought, would give us a series of mini-bear and mini-bull markets prior to a final accounting in which we would see the "real bear market" emerge. This real bear market should give us the "great values" that we haven't seen in stocks since the early 1980s.

Last week the liquidity and low rates finally started to "kick in." On December 5 we saw the Dow move above 9978 and above the psychological 10000 level. The bullishness that had never really disappeared suddenly broke out into the open. The stock market surged on December 5 as the 30-year T-bond broke almost three points on the futures.

Where do we go in this kind of wild market? The ideal is to be in T-bills with positions in ETFs such as DIA, SPY and QQQ. I've recommended that subscribers who want an upside hedge take limited positions in the above three. Why try to pick the stocks that will rally when you can pick the stock averages that have to advance with the market (after all, they ARE the market)?

In the end, you must have a strategy if you want to invest successfully. The strategy I've been recommending is **compounding.** To compound you must have income, money coming in. You can't compound with stocks that don't pay dividends — which is why I never buy a dividend-less stock.

Currently the ideal position is T-bills, money market funds, short maturity bonds, short maturing muni bonds, dividend paying stocks and above all – patience. Compounding always wins over time, but you must own securities that are going to stay in business and securities that throw off income, good times or bad.

**NOTES & QUOTES:** Despite Microsoft's billion-dollar advertising and promotion campaign, Windows XP is not selling well. Sales of PCs loaded with XP are flat. PC sales rose only 1% in the week after XP's launch on October 25 and climbed 2% the second week. When the economy was roaring, PC sales were up 10% to 20% after new MSFT software hit the market. The general sentiment towards computers now is "I'll wait, what I have is good enough."

* * * * *

How did the bailout of the airlines go? Here's who received government bailout money. United got $390 million, American got $359 billion, Delta got $327 million, Northwest got $248 million, Continental got $191 million, US Airways got $159 million and Southwest got $144 million. FedEx got $100 million, TWA got $78 million and America West got $60 million. Lowest on the totem pole – Grand Canyon Helicopters got a piddling $340 and Island Air Service got $775.

* * * * *

Which is the hottest group of spenders today? Why it's the teeny-boppers, the group that *The New York Times* calls "the hormonal wave." This is the under 25 crowd, the bunch born between 1979 and 1985. This group is a huge spending group, which evidently is called "Generation Y." There are 62 million of these kids and last year they spent $155 billion (I know because two of my five kids are in this group).

This is the group that the corporations are going after. Do you wonder why the movies are so lousy today? They're mostly aimed at this group. Do you wonder why the music is so lousy today? Same thing – the record companies are going after this group. The queen of Generation Y is evidently Britney Spears. She's brought back the mid-body and the navel. So all hail to Generation Y. And better be nice to them – they'll be running the nation in another twenty years.

* * * * *

After breaking into a few of the "untouched" Taliban caves, researchers got a good idea of what the terrorists are after. Their chief targets are or will be bridges, embassies, schools and amusement parks. The terrorist trainees came from 21 countries including Egypt, Bosnia, Kuwait, France, England, Jordan, Saudi Arabia and Turkey and other US allies.

Nearly all students were told to return to their native countries after training and "await orders" to carry out attacks on the US, class notes revealed. Two manuals of terrorism were both printed in the USA and titled, "Middle Eastern Bomb Design." and "Advanced Techniques for Making Explosives and Time-Delay Bombs." It is estimated that more than 5,000 recruits received training in one of the bin Laden camps.

* * * * *

Twenty-five of the 30 major league baseball teams lost money this year. How much? Half a billion dollars in total. You have to wonder how much longer teams can pay players those prodigious amounts. And you have to wonder how much longer fans will pay high prices for tickets.

Of course baseball tickets seem like bargains compared with pro football and pro basketball tickets. How much longer, is the big question.

* * * * *

Nobody appears to be talking about it, but the city of New York is in a mess. According to city comptroller, Alan Hevesi, New York has 50% more debt per resident than any other major American city and nearly double the debt it had 10 years ago. New York now has an horrific debt load of $40 billion. And 15 cents out of every dollar in taxes must now go to cover the city's debt.

What happens next to New York? More bonds? Cut backs in spending? A state of government bail-out? As the bear market moves on, the pressure on New York is going to be massive. The pressure is coming, believe it.

* * * * *

**DOUBLE-DIGIT EARNINGS:** Turning out double-digit earnings growth year after year has become almost a mandate for today's corporations. Indeed, double-digit earnings have become a test of a corporation's strength, and an integral part of the corporate culture.

Forget that the economy's been contracting, forget that a recession is on and that profits are being squeezed, the name of the game is "getting your stock up." How do you do that? You do it with double-digit earnings – in a word, growth.

The double-digit goal is not just confined to growth stocks, even the older more mature companies have been pressed into the double-digit vice. And if they make it or even appear to make it they will receive Wall Street's highest reward. Which is what? Which is a price/earnings ratio of 20 or 30 or 40 or 50 or well, you name it.

In 1999 the frenzy for double-digits hit its high. That year in the S&P 500 only 50 companies rose in value while 450 declined. But the 50 companies climbed so high that they took the averages with them. That was the year when investors would only pay for growth, growth and more growth. Dividends didn't mean anything, good cash flow counted for nothing, reliability meant nothing at all. The only thing that mattered was growth.

With the dot-com bust and the stock market collapse, the frenzy for double-digit growth cooled down. Expectations have calmed down, but they didn't disappear. Now with the market pushing higher, the expectations for double-digit growth are returning, heating up again.

Writes the *Washington Post*, "Corporate executives have incentives to play the growth game. Most have multi-million dollar compensation packages and that includes bonuses, stock and stock options, all directly tied to growth in earnings and share price."

In fact, CEOs who don't have a good growth story to tell or who can't deliver have a good chance of hitting the road. Note how almost daily we hear of some CEO of a large corporation who is leaving or is asked to leave.

As a result, we got the birth of the pro forma earnings. These are phony earnings that are arrived at by "leaving out" certain expenses that should be included in a corporation's statement. Finally, it's become so flagrant that last week the SEC warned that it might go after corporations which failed to disclose what they were leaving out in their pro forma earnings.

Another item that has appeared is the "better the last quarter by one cent" syndrome. Corporation after corporation has turned to the "penny-better theme" to jazz-up their growth record. Another technique is to talk a corporation's earnings down, lower expectations, and then come out with the "surprise," earnings are up a penny. Incredibly, Wall Street's analysts accepted these fake earnings.

The *Washington Post* writes, "Jeff Garten, dean of the Yale School of Management, interviewed 40 of the leading corporate chief executives for a new book. He said that many had told him that while they knew the expectations about earnings growth were often unreasonable, they had no choice but to participate. The system penalized anyone who didn't play the game."

I believe that much of the current rally is based on the unwritten thesis that US corporations are again heading for double-digit growth rates. This "tyranny of growth" has caused many corporations to expand too quickly or make stupid or ill-advised acquisitions, often in areas out of their expertise. In the end, stockholders pay for these mistakes of judgment or flights of ego.

Russell opinion – As the nation moves further and further into the world of global competition, it's going to be increasingly difficult to produce double-digit growth records. Those few executives that have produced double-digit growth records for their companies are now in high demand. They are lionized in business books, written up in magazines, placed on the lecture circuit, and offered positions as the head of corporations and asked to be on numerous corporate boards. They are usually given wide leeway in how they run their companies.

Happiest of Holidays to all my subscribers .

**Next Mailing: January 2, 2002**